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April 13, 1993

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Donna R. Searcy
Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Ms. Searcy:

Re: *CC Docket No. 92-296 - Simplification of the Depreciation Prescription Process*

RECEIVED

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

APR 13 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)
Simplification of the)
Depreciation Prescription)
Process)
_____)

CC Docket No. 92-296

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: April 13, 1993

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SUMMARY

The Pacific Companies and other local exchange carriers ("LECs") support the price cap carrier option as the best means to streamline the current burdensome and costly depreciation represcription process. This option will also further the Commission's objective in adopting incentive regulation -- to enable LECs to respond to changing technological, regulatory and market conditions.

With the price cap carrier option, the Commission will continue to authorize depreciation rates which are supportably in the public interest. Carriers will provide data for the Commission's analysis. Moreover, given the many safeguards described in the comments, it is highly unlikely that the hypothetical concerns of carrier manipulation would occur.

Other reasons to deny depreciation simplification are similarly suspect. The Commission must reject CCTA's mischaracterization of both the Commission and LECs as suggesting that depreciation policy and infrastructure development are interdependent. Even if they were, net additions is not an

states with data for state represcription purposes cannot be justified given a state's own ability to obtain data. Moreover, without the voluminous data currently required, the Commission will still have ample data from which to analyze carrier requests. The Commission should also reject any suggestion to lengthen the period between represcriptions. That would exacerbate the current problems as would MCI's suggestion to delay any change to the depreciation process until after the price cap regulation review.

While the Pacific Companies prefer the price cap carrier option, either the basic factors or depreciation rate range options could be tailored to provide the flexibility appropriate to price cap carriers. Broad ranges based on prospective (not historical) uses and lives which are applied to all accounts, required for all carriers and flash-cut implemented would be workable. Ranges would continue to be developed using current depreciation formulas.

As 1994 prescription companies, the Pacific Companies are concerned that they may be subject to another round of represcription under the cumbersome current process. In the event that the Commission's final decision cannot be implemented in time for our 1994 represcriptions, we request that the Commission extend the current rates until depreciation can be represcribed under the new process. Or, as further alternative the Commission should consider using the Pacific Companies as a test case to demonstrate that the price cap carrier option is a workable alternative to the current burdensome process.

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REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell ("the Pacific Companies") respectfully submit their reply to the comments filed concerning the simplification of the depreciation prescription process proposed by the above-captioned proceeding.¹

I. INTRODUCTION

Carriers subject to the current depreciation prescription process agree that simplifying that process is warranted. Of the four options proposed by the Commission, commenting local exchange carriers ("LECs") unanimously support the price cap carrier option. The Pacific Companies continue to urge the adoption of the price cap carrier option as the option most likely to accomplish the Commission's simplification and

¹ Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, Notice of Proposed Rulemaking, released December 29, 1992, ("NPRM").

incentive regulation objectives. That option offers the greatest potential to streamline today's burdensome and costly process. By adopting the price cap carrier option the Commission will also permit carriers to respond to technological, regulatory and market conditions in a timely manner without relinquishing any of its authority or control. This is consistent with the Commission's goals in the price cap proceeding.

The Pacific Companies will address specific comments on the price cap carrier option, objections by CCTA² and others to the Commission's proposals, and how the basic factors or rates options could be implemented to meet Commission objectives. We will also propose alternatives in the event that the simplified depreciation process is not ready to be implemented for the 1994 represcription.

II. DISCUSSION

A. The Price Cap Carrier Option Does Not Result In Any Loss Of Commission Control Over Depreciation Rates.

The primary concern expressed by state regulators and other commentators is that adoption of the price cap carrier option will result in the Commission's loss of control over the depreciation process. That is untrue. The Commission, whether the price cap carrier option or any other option is chosen, will ultimately choose depreciation rates which can be supported as

² Comments of the California Cable Television Association ("CCTA"), dated March 10, 1993.

being in the public interest. The dire portrayal of a depreciation free-for-all in which the Commission is inexorably bound to accept whatever depreciation rates a LEC may propose is totally unrealistic. The Commission will authorize depreciation rates which it believes support just and reasonable rates. That decision will be based on its reasoned analysis of whatever data it deems necessary to determine that the rates are appropriate. If the initial information provided by a carrier is not sufficient for that determination, a carrier will provide additional support because it is in its best interest to do so. Without doubt, a carrier will provide whatever the Commission needs or requests to substantiate the carrier's proposed rates.

By initiating this proceeding, the Commission acknowledges, however, that the current burdensome process, developed when all carriers were subject to rate of return regulation, can be revised given the significant change in technology, regulation and market conditions. With the change to incentive regulation, the Commission recognizes that the extent of Commission scrutiny and direction that may have been appropriate under a rate of return process is no longer appropriate.³ An account-by-account represetation process, a vestige of rate of return micromanagement, is also no longer necessary or appropriate.

³ NPRM, para. 8.

B. Safeguards Minimize The Incentive For Manipulation Of Earnings.

Commentors opposing the price cap carrier option advocate continued micromanagement out of concern that LECs have the ability to affect the sharing of earnings or prices if earnings are too high or too low.⁴ But, commentors do not provide any more than generalized, theoretical concerns about situations that could occur under extremes of potential earnings scenarios.⁵

The comments of the Pacific Companies and other commentors describe significant safeguards that protect against manipulation.⁶ There is no reason to anticipate that those safeguards will fail to protect against the commentors' theoretical concerns.

⁴ Commentors include the following: AT&T Comments, pp. 8-10; Comments by General Services Administration, pp. 2-4; Comments of California, ("CPUC"), pp. 8-10.

⁵ MCI's projection of the effect on sharing should be rejected as absurd. MCI, n. 6, n. 3. MCI's farfetched example

C. CCTA Study Results Are Misleading And Should Be Considered Accordingly.

CCTA is opposed to all of the Commission's proposed options for two reasons. First, it claims that its study shows that increased depreciation rates do not lead to increased investment as it alleges that carriers promised. Second, it believes that none of the options will result in depreciation rates that reflect an individual company's true cost recovery patterns.⁷

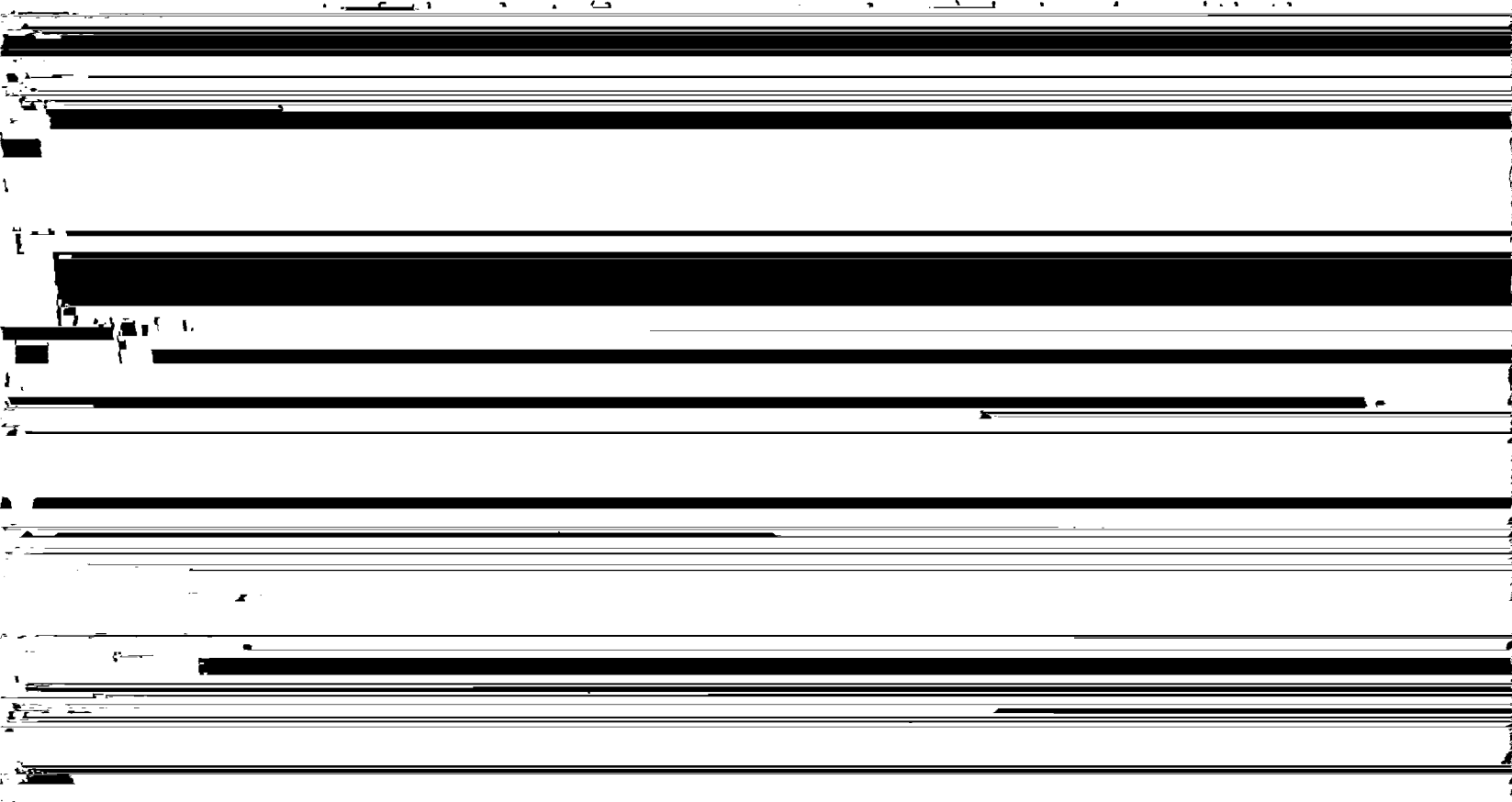
The Commission should note CCTA's novel method of commenting in this proceeding. CCTA first alleges a specious premise; then it refutes the specious premise. Specifically, CCTA characterizes the LECs as arguing a one-to-one correlation between depreciation expense increases and infrastructure improvement. But, contrary to what CCTA would have the Commission believe, the Pacific Companies have never said that increased depreciation rates would result in investment in infrastructure. Without question, the ability to recover capital investment is an important factor in investment decisions. Common sense requires reluctance in investing in new plant if one has had difficulty recovering past investment. The historical reality is that there has been consistently insufficient recovery of capital investment. That is good reason for conservatism in investment decisions. However, the Pacific Companies have always clearly said that depreciation recovery is only one among several

⁷ CCTA, Summary, pp. i, ii.

areas where regulators could provide incentives for accelerated investment in infrastructure development.

But, in addition and more importantly, there is no validity to CCTA's premise that recovery of past investment must determine the Commission's decisions on what recovery is appropriate for future investments. Depreciation rates for future investments should be determined on the basis of the lives and future net salvage of the assets -- not how much of its past investment a carrier has recovered.

ICA's related argument -- that the amount of past investment recovered that is reinvested in the basic services network should be a factor in determination recovery of future assets -- must also be rejected.⁸ A LEC's reinvestment strategy has nothing to do with determining depreciation rates. Depreciation is the process of allocating the cost of plant over its service life.⁹ Depreciation is intended to return the



not occurred.¹⁰ But CCTA's study must be carefully examined. The Pacific Companies believe that net additions is a misleading measurement. CCTA states that "... depreciation expense exceeded net additions by a range of 1.1 times to 6.23 times". This is erroneous if it is meant to indicate that increases in depreciation significantly outpaced increases in telephone network investment. Net additions, gross additions minus retirements, is not an appropriate measure. "Net additions" indicates only the incremental change in dollar amount of assets purchased at different times and potentially at different prices. "Net additions" or the amount of incremental change can be affected by many circumstances unrelated to the extent of investment activity. For example, "net additions" does not reflect the effect of introducing assets that are less costly than those retired. Replacing copper with the same dollar amount of fiber would not result in any "net addition", yet that would be significant investment to improve the network. Gross additions, however, would be a reasonable measure as this example

been a positive \$983M. As shown in Table 1 below, there is a

next, different between Pacific Bell's gross additions and the

decline in depreciation expense.¹⁴ Moreover, the reduced depreciation expense (from \$1.7 billion to \$1.6 billion) also reflects the end of the reserve deficiency amortization period.

CCTA's second reason for rejecting all of the proposed simplification options is that none of the proposals would result in the quantification of depreciation levels reflective of an individual company's true cost recovery patterns.¹⁵ The implication to be drawn from CCTA's position is that the current process should be maintained because it does reflect a company's true cost recovery pattern. That can hardly be true given the accuracy of the current process history of depreciation reserve deficiencies that recur despite repeated Commission efforts to determine proper recovery levels. For example, in 1991, shortly after the Commission addressed the 1987 depreciation reserve deficiency, Pacific Bell estimated a reserve imbalance of \$1.8 billion based on its proposed parameters. Based on the Commission's prescription factors, the deficiency was \$519M. Other carriers have similar experience. The Commission's Staff's study on Bell Atlantic's annual theoretical reserve study shows a continuing reserve deficiency of \$845 million.¹⁶ Given this state of affairs, there is little basis for any confidence that

¹⁴ Revision to Amend Part 31, Uniform System of Accounts for Class A & Class B, Telephone Companies as it relates to the treatment of certain individual items of furniture and equipment

the current process results in depreciation levels reflective of a true cost recovery pattern.

D. The Commission Must Reject Suggestions To Maintain The Current Process.

Several commentors question the burden of the current depreciation prescription process.¹⁷ Some commentors doubt that the options proposed will significantly reduce that burden. The California Public Utilities Commission ("CPUC") suggests that any burden on local exchange carriers ("LECs") is self-imposed. That is wrong. The CPUC is mistaken in thinking that the voluminous information provided by the LECs is not required by the FCC.¹⁸ Pacific Bell's analysis of its 1991 Depreciation Represcription Study Binder filed with the Commission shows that Commission-required information comprised approximately 804 pages (or 84%) of the Binder. The additional 158 pages (or 16%) were either responses to the Commission's further requests for data or narratives that were offered to meet Pacific Bell's burden of proof that its rate requests were warranted.¹⁹

¹⁷ Comments of the Idaho Public Utilities Commission, p. 4; Initial Comments of the New York State Dept. of Public Service, pp. 5, 6.; Utah Division of Public Utilities, p. 1.

¹⁸ Comments of California, dated March 9, 1993, p. 2; see also NYDPS, pp. 6, 7.

¹⁹ MCI claims that the LECs have failed to show that their costs are any more than normal business expenses associated with

Eliminating the bulk of these required pages would result in significant savings for carriers. The Pacific Companies will continue to maintain records for income tax and valuation purposes under any of the options proposed. Continuing property records will also be maintained as required by the Uniform System of Accounts,²⁰ but the reduction in the tremendous amount of time and resources that are required to develop, assemble, and verify the binder material will be a significant savings.

Some state regulators urge the Commission to continue the current process that requires carriers to provide extensive historical studies because that data benefits the states' depreciation represcription process. This is not a sufficient reason to require all LECs to continue the burdensome current process. Not all states rely on the Commission's analyses. Many states use procedures which differ from the Commission's methodology. for example. in their use of ELG or in prescribed

supporting data required currently, regulators will not be able to analyze a depreciation rate request. As support, CCTA cites to Pacific Bell's 1991 request for \$301 million annual increase in depreciation rates for which the Commission granted an increase of \$23.2 million.²¹ The Commission does not need all of the costly and time consuming historical studies currently required. Carriers will continue to analyze underlying depreciation factors to determine the reasonableness of their depreciation rates but significant efficiencies can occur when the extensive historical studies are eliminated. The Commission will continue to receive data from ARMIS Reports, tariff reports and its own informal data requests to carriers. These and industry studies will provide data that the Commission can use to establish rates based on realistic estimates of future use and lives which is the appropriate focus for determining depreciation rates. As the pace of technological and market changes accelerates, binders of data on historical usage will become increasingly less useful to estimate future lives.

The Commission must reject CCTA's suggestion that simplification could be accomplished by extending a prescription

²¹ Pacific Bell's request was absolutely within the bounds of reasonableness for a company with \$22 billion in assets. The Commission ordered accruals of \$994 million in 1989 and \$756 million in 1991 for a large IEC with assets similar in amount and kind in many respects to that of Pacific Bell. An alternative explanation for the disparity in depreciation accruals granted to Pacific Bell and to the other large IEC may be the disturbing lack of recognition by the Commission that the LECs have experienced dramatic reductions in the useful lives of their assets similar to those experienced by that IEC.

period from three years to four years. LECs must be able to adjust rates more frequently than the current three year period because of the accelerating rate of change in the telecommunications industry. Extending the applicable period for depreciation rates to four years is exactly contrary to sound depreciation policy and to the Commission's objectives in the price cap proceeding -- to permit carriers to respond to rapidly changing conditions.²² CCTA's suggestion that the technical update process will protect LECs from any potential adverse effect from the longer review periods is also wrong. The technical update process is only a simple depreciation rate adjustment for all accounts based on minor changes in the average remaining lives and current reserve levels. The technical update does not permit a change to the basic factors that underlie the rate calculation. Thus, the technical update is not a viable means to correct for significant technological, regulatory and market condition changes that occur in select asset groups between represcriptions. Extending the current three year represcription cycle to four years only exacerbates the problem of depreciation rates which cannot be adjusted to respond to changing conditions.

²² The Commission, recognizing the carrier's need to respond to competitive market pressures, changed AT&T's represcription filing period from three years to every other year. Modification of the Commission's Depreciation Prescription Practices as Applied to AT&T and the Prescription of Revised AT&T Depreciation Rates, Memorandum Order and Opinion, 4 FCC Rcd 8567, (1989).

Finally, the Commission should reject MCI's suggestion that no change to the depreciation process should occur until after the first price cap regulation review.²³ The Commission adopted incentive regulation in order to encourage carrier productivity and innovation. MCI's suggestion is directly contrary to the intent of the price cap proceeding. Simplification of the depreciation process is one method by which a carrier can attempt greater productivity. As described above, the savings in time and people resources from not being required to develop voluminous studies will be significant.

E. The Basic Factors Or Depreciation Rate Range Options Would Be An Improvement Over Current Process If Properly Implemented.

Many commentators favor the basic factors or depreciation rate range options. As previously stated, we believe that the price cap carrier option best accomplishes the Commission's goals of simplifying the current process and will also further the price cap regulation objectives. But, if properly implemented, the basic factors or depreciation rate range options would be workable and provide some improvement over the current process. Under the range options, carriers would still provide the basic information as proposed for the price cap carrier option but the hefty burden of historical data would be eliminated. This would be a significant savings.

²³ MCI, pp. 9-10.

As previously discussed in our Comments,²⁴ however, if one of these options is chosen, the Commission must set broad ranges based on forward-looking analysis, not on data that cannot reflect changing conditions or asset lives. The ranges must apply to all accounts, for all carriers and be implemented at the same time. Price Cap carriers must be able to choose any rate within the approved range. Contrary to MCI's suggestion, there is no reason to restrict the percentage change of depreciation ~~ranges between periods as long as the changed rate is within~~

investment it has made, how much has been recovered, the life of that investment and the extent of reserve deficiency, if any.

Updating of ranges should occur on a regular basis but LECs should not be required to provide voluminous historical studies as currently required. The Commission can use industry studies to determine appropriate adjustments to the ranges, thereby retaining the efficiencies resulting from this simplification effort.

If the Commission selects either of the range options, however, the Commission should not foreclose the possibility of revisiting the price cap carrier option in the near future as market conditions, regulation and technology demand increasing competitive responsiveness for LECs.

F. The Pacific Companies' 1994 Depreciation Represcriptions Could Be Deferred Until The New Process Can Be Implemented.

The Pacific Companies are due for depreciation represcription next year. In the event that the Commission does not adopt a simplified depreciation process in time for the new process to be implemented for the 1994 prescription, the Pacific Companies respectfully request that the Commission defer their 1994 represcriptions until the new methodology can be used. Given the Commission's recognition that the current process is costly and cumbersome, it would not be in the public interest for the Pacific Companies to undertake the current process, expending significant but limited resources, when the process will be changed within a short time. On the other hand, the Commission

must take whatever time it needs to reach a reasoned decision about the new process. Thus, one viable alternative to continuing to require the companies to follow the represcription process that the Commission intends to change would be for the Commission to extend the applicability of the Pacific Companies' current depreciation rates until such time as depreciation can be represcribed under the new process. The current depreciation rates will continue to apply until the new process is in place and can be used to seek a change in depreciation rates.

The Pacific Companies suggest another alternative. We would be willing to act as a test model for the price cap carrier option. Pacific Bell is well suited to be a test case because it has the largest study area among the companies to be represcribed in 1994 and could demonstrate the adaptability of the price cap option for any price cap company. Applying the price cap carrier option as the basis of the 1994 Pacific Companies' represcription offers the Commission an opportunity to implement that option in a limited fashion and to confirm the option's suitability and advantages. At the same time the Pacific Companies will avoid the inefficient expenditures of resources required by the current process.

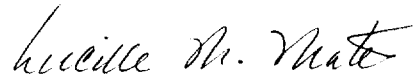
III. CONCLUSION

The record established by the comments submitted in this proceeding shows that simplification of the depreciation represcription process is a timely undertaking; that carriers subject to the depreciation represcription process support the

price cap carrier option; and that safeguards can protect against concerns of manipulation of depreciation expense to the detriment of the ratepayer. The Pacific Companies urge the Commission to adopt the price cap carrier option which, in addition to promising significant administrative savings, would allow price cap carriers to set depreciation rates which respond to rapid technological, regulatory and market changes in an increasingly competitive environment consistent with the goals of price cap regulation. In this manner, the Commission will continue to implement its policies encouraging competition and technological advancement.

Respectfully submitted,

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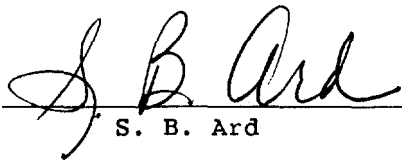
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Date: April 13, 1993

CERTIFICATE OF SERVICE

I, S. B. Ard, hereby certify that copies of the foregoing "REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL", re CC Dkt 92-296, were served by hand or by first-class United States mail, postage prepaid, upon the parties appearing on the attached Service List this 13th day of April, 1993.

By:


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